INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25136

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

The provisions in California Revenue and Taxation Code (RTC) section 25136, subdivision (b), were originally enacted in 2009 and are operative for taxable years beginning on or after January 1, 2011. Subdivision (b) of RTC section 25136 requires a market-based approach for assignment of sales of other than tangible personal property for all taxpayers who elect to use single sales factor apportionment formula under RTC section 25128.5, also enacted in 2009 and operative for taxable years beginning on or after January 1, 2011. There is no existing regulation under RTC section 25136, subdivision (b), to explain to taxpayers how the market based assignment of sales of other than tangible personal property will operate. Subdivision (c) of RTC section 25136 specifically provides that "[t]he Franchise Tax Board may prescribe those regulations as necessary or appropriate to carry out the purposes of subdivision (b)."

SPECIFIC PURPOSE OF THE MODIFICATION OF THE REGULATION

The purpose of proposed California Code of Regulations (CCR) section 25136(b) is to instruct multistate taxpayers who make a single-sales factor election on how to assign sales of other than sales of tangible personal property based on the location of the taxpayer's market. The regulation will achieve that purpose by providing definitions, guidelines, and examples that provide information beyond that provided by the underlying code section.

Currently, CCR section 25136 generally provides that gross receipts from sales of other than tangible personal property are assigned to this state based on income-producing activity/cost of performance rules. Those taxpayers who do not elect a single-sales factor formula under RTC section 25128.5 and CCR section 25128.5 must assign sales of other than tangible personal property pursuant to subdivision (a) of RTC section 25136 and the existing regulation provisions that give guidance for the operation of the income-producing activity/cost of performance rules. These existing regulation provisions will be renumbered CCR section 25136(a) to correspond with the underlying corresponding statute, RTC section 25136, subdivision (a), as part of this rulemaking project.

NECESSITY

During 2009, the California Legislature adopted a new RTC section 25136, now numbered RTC section 25136, subdivision (b), operative for taxable years beginning on or after January 1, 2011. During 2010, the California Legislature amended RTC section 25136 to retain the income-producing/cost of performance rules for assignment of sales of other than tangible personal property for taxpayers who do not make a single-sales factor election. As a result, the statute is currently divided into two parts: for those taxpayers who do not make a single-sales factor election, subdivision (a) of RTC section 25136 applies and provides the income-producing activity/cost of performance rules for assignment of sales of other than tangible personal property, and for those taxpayers who do make a single-sales factor apportionment formula election, subdivision (b) of RTC section 25136 applies and provides the market

based rules for assignment of sales of other than tangible personal property. Subdivision (c) of RTC section 25136 specifically authorizes the Franchise Tax Board to issue necessary or appropriate regulations regarding the assignment of sales of other than tangible personal property based on market rules under subdivision (b) of RTC section 25136. Since subdivision (b) of RTC section 25136 lacks specificity regarding assignment of sales of other than tangible personal property based on the location of where the benefit of the services is received or the location of the use of intangible property, a regulation is necessary to inform taxpayers how the market-based rules are to be applied.

There are many issues to be addressed by way of regulation so that taxpayers understand the meaning of the terms and their application in various situations. Some of these issues include: how is it determined where a customer received the benefit of services or where the intangible property was used, what documentation is available to the taxpayer, what happens if there is no documentation available to the taxpayer, what should be the order of the best evidence, and whether there are any special circumstances that should be addressed by special rules.

The Franchise Tax Board looked to existing statutes and regulations of all states which have adopted similar market rules to use some of the definitions and terms as a model. These states' statutes and regulations are listed in the 50 state analysis which was posted on the Franchise Tax Board's website prior to the first interested parties meeting on February 10, 2010. The Franchise Tax Board also conducted two other interested parties meetings in 2010 in order to obtain input from taxpayers and other members of the interested public. Explanations for draft language were provided in advance of those meetings.

Subsection (a) of the regulation states the general rule that sales of other than tangible personal property are in this state if the taxpayer's market is in this state. These market-based rules for assignment of sales of other than tangible personal property are in addition to those described in RTC section 25135, which contains the rules for assignment of sales of tangible personal property.

Subsection (b) defines terms contained within the regulation. These definitions were primarily modeled after definitions utilized by other states and discussed at the three interested parties meetings held in February, July and November 2010.

In subsection (b)(1) the term "benefit of a service is received" is defined as the location where the taxpayer's customer has either directly or indirectly received value from the delivery of a service. The definition is provided to explain the meaning of the term as used in the statute. Where the benefit is received is determined by the use made of the service by the taxpayer's customer.

The examples in subsection (b)(1) are provided to illustrate where the benefit of a service is received for purposes of the statute in specific situations. The examples were modeled from those utilized by other states with similar statutes and/or regulations including Georgia, Illinois, Iowa, Ohio and Wisconsin.

In subsection (b)(2) the term "service" is defined as activities engaged in by one for another for consideration. The definition excludes activities outside the taxpayer’s regular course of

business as well as activities undertaken for other members of the taxpayer's unitary business. These exclusions are consistent with the provisions of CCR section 25134 which states only the gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business shall be included in the sales factor and with CCR section 25106.5-1 which eliminates transactions between members of a unitary business.

Subsection (b)(3) defines the term "cannot be determined" as meaning that the taxpayer's records, or the records of the taxpayer's customer available to the taxpayer, do not indicate the location where the benefit of the service was received or where the intangible property was used. Comments at the interested parties meetings expressed concern as to how to determine where the benefit of the service was received or location of the use of intangible property in the event there was no available documentation that provided that information. As a result, it was decided that there should be a reasonable alternative method which would reliably estimate the location of the market in the event actual taxpayer records do not exist. The alternative method is a reasonable approximation of the taxpayer's market and is defined and discussed below.

In subsection (b)(4) the definition of "commercial domicile" is defined as the place where the trade or business is directed or managed by the taxpayer. It is based on RTC section 25120, subdivision (b).

Subsection (b)(5) lists, without limitation, twenty-two (22) specific terms and ends with the catch-all, "other similar intangible assets." This definition is based on a combination of various other states' definitions, including Georgia and Illinois. Comments received at the first interested parties meeting indicated that taxpayers wanted to know with a degree of certainty what "intangible property" means in connection with this regulation. Listing items provides certainty with respect to the items listed but does not preclude other items from being included.

In subsections (b)(5)(A), (B) and (C) the terms "marketing intangible," "non-marketing and manufacturing intangible," and "mixed intangible" are defined based on Massachusetts' law on assignment of intangible property. A "marketing intangible" is intangible property whose primary value lies in the marketing of the intangible property. A "non-marketing and manufacturing intangible" is intangible property where the value of the intangible property lies predominately in its non-marketing or manufacturing use. "Mixed intangible" is intangible property whose value includes both the license of a marketing intangible property and license of a non-marketing or manufacturing intangible property. Subsection (d)(2) of this regulation provides different rules of numerator assignment for the use of intangibles based upon these three categories of intangibles, so that it is necessary to define what is included in each category. The reasons for making different assignments on the basis of the concepts of marketing and manufacturing intangibles are explained below in the discussion of the provisions themselves.

In subsection (b)(6) the term "intangible personal property is used" is defined as the location where the intangible property is employed by the taxpayer's customer or licensee. This language is based on RTC section 25127.

In subsection (b)(7) the term "reasonably approximated" is defined by reference to the business of the taxpayer's customer. Reasonable approximations are used when location cannot be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records. Discussion at the three interested parties meetings indicated that there needed to be an alternative way to establish a taxpayer's market where the primary source of evidence, i.e. the contract or the taxpayer's books and records, did not establish the taxpayer's market for the sale. The concept of "reasonable approximation" is a reliable alternative if the approximation is done in a way that takes into account the business activities of the taxpayer's customer. Specific information should be used over general information for reasonable approximations. Population can be used as a basis for reasonable approximations.

In subsection (b)(8) the term "to the extent" is defined to make clear that a receipt is to be divided proportionally between states when it relates to activities in more than one state. Comments at the three interested parties meetings held in 2010 indicated that the location where the benefit of the service is received and the location of the use of the intangible property should be assigned only to California in direct proportion to what was received or located in California compared with other states. This provision is consistent with the intent of the underlying statute, RTC section 25136, subdivision (b), which specifically states "(1) Sales from services are in this state *to the extent* the purchaser of the service received the benefit of the service in this state. (2) Sales from intangible property are in this state *to the extent* the property is used in this state." [Emphasis added.] This language is also consistent with other states' statutes and/or regulations which have adopted a similar market based rule for assignment of sales to the extent that services are received and intangible property is used in other states. The rule provided by RTC section 25136, subdivision (b), is different from the rule provided in RTC section 25136, subdivision (a), which assigns all of a receipt to the state with the preponderance of the activities.

Subsection (c) addresses assignment of sales from services to the extent that the benefit of the service is received in this state by the taxpayer's customer. Comments at the interested parties meetings of February and July 2010 indicated a consensus that rules assigning sales to individual customers should be different than corporate or other business entity customers. The rationale was that where the customer was an individual that customer would most likely receive the benefit of the service at his or her home address and the home address would most of the time be the billing address, whereas for a corporate or business customer the location of receipt of the benefit of the services could be in a number of places, not necessarily the billing address. As a result, there are two different sets of cascading rules: one for individuals and one for corporate or other business entities. This introductory language mirrors the language of the underlying statute, RTC section 25136 subdivision (b), and is segue to the cascading rules below.

Subsection (c)(1) sets forth the billing address as the primary rule for assigning sales of services where the taxpayer's customer is an individual. Subsection (c)(1) also provides a safe harbor rule for taxpayers so that if the taxpayer uses the individual customer's billing address as the mechanism for assignment of the sales, then the Franchise Tax Board must accept this presumptively correct assignment. This language was added because comments at the interested parties meetings indicated concern that the Franchise Tax Board's auditors

would attempt to overcome the presumption of billing address by looking at individual customers one by one and that, in light of the small amounts of money at stake for any individual customer, this would be overly burdensome for taxpayers. This “safe harbor” will not prevent the Franchise Tax Board from auditing to ensure that billing address was in fact the method utilized and that it was done correctly.

Subsection (c)(1)(A) sets forth the secondary rule for assignment which is applicable only when the taxpayer establishes by a preponderance of evidence that either the contract between the taxpayer and its customer or the taxpayer's books and records kept in the regular course of its business indicate the extent to which the benefit of the service was received in this state. If the taxpayer uses this alternative method of assigning the sales, this subsection allows the Franchise Tax Board the right to audit the alternative method to determine whether or not the taxpayer has overcome the presumption that the benefit of the service was received at the customer’s billing address and also that the taxpayer's method reasonably reflects where the benefit of the service was received by the taxpayer's customers. It was agreed by both members of the public and staff of the Franchise Tax Board at the November 8, 2010 interested parties meeting that the Franchise Tax Board should have the right to audit any alternate method to the safe harbor rule used by the taxpayer in the event the taxpayer chose to not avail itself of the safe harbor rule.

If the assignment cannot be determined under the alternatives set forth in subsections (c)(1) and (c)(1)(A), then subsection (c)(1)(B) states the determination of the location shall be reasonably approximated. As outlined above in the definitional language, this alternative method was discussed at the interested parties meetings as the best alternate where there is no available documentation to determine the location where the benefit of the services was received or if available documentation indicated that the location of the benefit of the service was received in a different place than indicated by the contract or the taxpayer's books and records.

Subsection (c)(1)(C) provides examples illustrating how the cascading rules in subsection (c)(1) operate. Example 1 illustrates assignment under subsection (c)(1). Example 2 provides an example of when the billing address presumption is overcome and assignment under subsection (c)(1)(A) is proper. Example 3 illustrates when the billing address presumption is not overcome by the taxpayer and therefore assignment under subsection (c)(1) is proper. Taxpayers at the interested parties meetings requested that an example be provided for each of the cascading rules. These examples were discussed at length at the interested parties meetings of 2010. One more example needs to be added to illustrate assignment by reasonable approximation under (c)(1)(B).

Subsection (c)(2) addresses assignment of sales where the benefit of the services was received by corporate or other business entities. The majority of members of the public at the interested parties meetings concurred that the cascading rules set forth below would be the most logical step-down approach to assignment of sales to corporate or other business entities because taxpayers, depending on whether they are small or large, sophisticated or simple, will have different levels of available information. Some taxpayers will have extensive contract provisions or books and records indicating the location where the benefit of the service was received, and other taxpayers may not have the requisite information in

either a contract, if they have one at all, or in their books and records to establish the location where the benefit of the service was received. As a result, the cascading rules set forth below were developed in order of the best evidence or data. The cascading rules also potentially avoid the situation of nowhere sales where sales escape inclusion in any state's apportionment formula. Another concern voiced by both taxpayers and Franchise Tax Board auditors alike was the fear that either might have the ability to "cherry pick" the "option" that increased or decreased the sales assigned to California, which in turn would increase or decrease the overall tax assessment, depending upon the desired effect of the party choosing the option. Consequently, the first cascading rule is set forth as a presumption that may only be overcome by a preponderance of the evidence. The effect is that a taxpayer or the Franchise Tax Board may only get to the second cascading rule of reasonable approximation if the taxpayer or the Franchise Tax Board overcomes the presumption that the contract or the taxpayer's books and records establish the location of where the benefit of the services is received. Likewise, the taxpayer or the Franchise Tax Board may only get to the third cascading rule of the location from which the customer made the order if the location of where the benefit was received cannot be reasonably approximated. Finally, the taxpayer or the Franchise Tax Board may not use the last resort rule of the billing address unless the ordering location cannot be determined.

Subsection (c)(2)(A) sets forth the first rule of assignment which provides that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records are presumed to establish the location where the benefit of the service is received, notwithstanding the billing address of the taxpayer's customer. As discussed above, participants at the interested parties' meetings felt that the contract or the taxpayer's books and records was the best and most reliable data and therefore should be the primary sources of determining the location where the benefit of the service was received. The presumption may be overcome by a preponderance of the evidence that the contract and the books and records do not indicate the actual location of where the benefit of the service was received.

Subsection (c)(2)(B) sets forth the second rule of assignment that the location where the benefit is received is to be reasonably approximated by reference to the activities of the taxpayer's customer's activities. The second rule only applies if the presumption in favor of the first assignment rule is overcome. Again, interested parties meetings participants felt that in the absence of best evidence, i.e. the contract or the taxpayer's books and records, a reasonable approximation of the location of the taxpayer's market would be the best alternate method of establishing the taxpayer's market.

Subsection (c)(2)(C) sets forth the third rule of assignment which is the location from which the taxpayer's customer placed the order for the service. This rule only applies if where the benefit was received cannot be determined under the first two rules provided in subsections (c)(2)(A) or (B). There will be some situations when the contract between the taxpayer and its customer, or the taxpayer's books and records, will not in fact indicate the location where the benefit of the services was received and where the location where the benefit of the services was received cannot be reasonably approximated. This provision is the third-in-line cascading rule that seeks to establish the taxpayer's market in the event of a lack of best evidence, i.e. the contract, the taxpayer's books and records, and the inability to reasonably

approximate the location of the taxpayer's market. This alternative is only available in the event the first two cascading rules cannot determine the location where the benefit of the service was received.

Subsection (c)(2)(D) sets forth the final rule of assignment: taxpayer's customer's billing address. This final rule is a catch-all when none of the provisions above can establish the location where the benefit of the services was received.

Subsection (c)(2)(E) gives examples showing how the cascading rules in subsection (c)(2) operate. Examples I, 2 and 3 illustrate assignment under subsection (c)(2)(A) using a taxpayer's books and records. Example 4.a illustrates assignment under subsection (c)(2)(A) using a taxpayer's books and records and example 4.b illustrates assignment under subsection (c)(2)(B) by reasonably approximating where the benefit of the services was received. Example 5.a illustrates assignment under subsection (c)(2)(C) when the first three cascading rules are unavailable and the sale must be assigned to the location from where the services were ordered. Example 5.b illustrates subsection (c)(2)(D) where the first four cascading rules are unavailable and the sale must be assigned to the customer's billing address. Members of the public at the interested parties meetings wanted examples for each cascading rule. These examples were discussed at the interested parties meetings.

Subsection (d) addresses assignment of sales from intangible property. Sales are assigned to this state to the extent the intangible property is used in this state. This introductory provision mirrors the language of RTC section 25136, subdivision (b). It is a segue to the cascading rules set forth below. A distinction is made in this regulation between the complete transfer of all rights in the intangible property and the lease or other use of intangible property. Where there is a complete transfer of rights, usually the taxpayer has no access to information as to what its purchaser does with the intangible property after the purchase. On the other hand, where the intangible property is leased or put to other similar use, the taxpayer in many circumstances will know what is being done with the intangible property.

In many cases, the licensee pays a fee to the licensor based on a percentage of the sales of the tangible personal property produced by the customer that contains the licensed intangible. To verify the accuracy of the fee paid, the licensor may have access to this information. Because of this on-going relationship between the taxpayer and its customer, the taxpayer may be able to receive, or have the right to receive, information regarding the "use" of its property. This may include the ability to have the licensee provide information regarding its sales of the products manufactured pursuant to the licensing agreement. Therefore the rules for the sales from the use, licensing, lease or rental of intangible property contain a look-through from the manufacturer to the ultimate customer who buys the product which is produced at least in part with the technology of the licensor in order to properly assign the royalty receipts. This provision is consistent with other states who assign sales of intangible property to the ultimate customer: Indiana, Kentucky, Massachusetts, Missouri, Minnesota, North Carolina, and Wisconsin. As a result of the distinctions in a sale of intangible property where a complete transfer of all property rights has been made and a sale of intangible property where the property is leased or otherwise used, the regulation contains different cascading rules for each circumstance. The series of cascading rules of

assignment recognize the extent to which the taxpayer has knowledge of where the purchaser will use the intangible property.

Subsection (d)(1) addresses assignment of sales from intangible property where a complete transfer of all property rights for a jurisdiction or jurisdictions has been made.

Subsection (d)(1)(A) sets forth the first assignment rule for a sale where a complete transfer of all rights in intangible property has occurred. It provides that if the contract between the taxpayer and the purchaser indicate the extent of the location[s] where the purchaser will use intangible property at the time of purchase, then the assignment will be on that basis. Comments at the interested parties meetings indicate that the contract or the taxpayer's books and records is the best evidence of where it is intended that the intangible property will be used at the time of the transfer. Subsection (d)(1)(A) continues by stating that if the contract or the taxpayer's books and records do not specify where the purchaser will use the property, then the use the taxpayer made of the intangible property prior to the purchase will be used. This is based upon an assumption that the purchaser will use the property where the taxpayer had used it. If the transfer of ownership is for use in limited jurisdictions the contract will so provide. The presumption may be overcome by a preponderance of the evidence that the actual location of the use by the purchaser is not consistent with the terms of the contract or the taxpayer's books and records.

Subsection (d)(1)(B) provides that if the assignment cannot be made by subsection (d)(1)(A), then the location of the use of the intangible property shall be reasonably approximated by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser will use the intangible at the time of the purchase, to the extent this information is available to the taxpayer. This rule assumes that the purchaser will use the intangible where it is doing business at the time of purchase. This rule also contains a limitation that the taxpayer cannot assign the use of the intangible to places where the purchaser does not conduct its business at the time of purchase. One way to estimate where the intangible will be used is to assume an even spread of use based upon the population of the jurisdictions where the purchaser conducts its business. If population is the reasonable approximation used, then the population must be the U.S. population unless the intangible property is currently being materially used in other parts of the world and it can be shown that the purchaser will continue to do so. If this can be shown, then, the population of countries where the intangible property is being materially used shall be added to the U.S. population. This limitation is provided to avoid the taxpayer estimating the use of the intangible on a worldwide basis when the purchaser does not currently operate throughout the world, even if the transfer of title gives the right to the purchaser to use the intangible everywhere.

Subsection (d)(1)(C) provides the final place of assignment as the billing address of the purchaser. This is a catch-all rule and only applies if assignment cannot be made under subsection (A) or (B).

Subsection (d)(1)(D) provides examples showing how the cascading rules in subsection (d)(1) operate. Example 1 involves a sale of 100% of the stock in a business and makes the assignment based upon where the assets controlled by the intangible are located and will be used by the purchaser. This is accomplished by reference to the apportionment factors of

the subsidiary that is sold. This is an application of the subsection (d)(1)(A) rule. Example 2 illustrates an assignment under the second rule based upon the taxpayer's knowledge of where the purchaser was doing business under subsection (d)(1)(B). Example 3 illustrates circumstances when the final alternative, the purchaser's billing address, under subsection (d)(1)(C) would apply. Members of the public at the interested parties meetings requested examples for each cascading rule. These examples were discussed at the interested parties meetings.

Subsection (d)(2) addresses assignment of sales of intangible property where the property is licensed, leased, rented or otherwise used. This introductory language segues to the cascading rules. Assignment is based on three different criteria: whether the value lies in the marketing of the intangible property, whether the value is in a non-marketing or manufacturing purpose, or whether the value is a mixture of marketing and non-marketing or manufacturing purposes. These distinctions, which are discussed at length in the definitional section, are based on a Massachusetts law for assignment of sales where intangible property is leased or otherwise similarly used. Members of the public at the interested parties meetings felt the distinctions and different assignment provisions based on the distinctions were a better and reasonable alternative to the blanket assignment of all license-type sales either to the ultimate customer or alternatively to the licensee.

Subsection (d)(2) sets for the rules for assigning receipts from the licensing, leasing, rental or other use of intangible property, as defined in subsection (b)(5), not including sales of intangible property provided for in subsection(d)(1).

Subsection (d)(2)(A), entitled "Marketing intangibles" provides the rules for the assignment of sales where a license is granted to use intangible property in connection with the marketing of goods, services or other items to customers in this state. Because the value of these types of intangible are primarily derived from their use in marketing underlying products to consumers, the receipts from these types of licensing agreements are assigned to the location of the retail customers who purchased the goods, services or other items that are marketed in connection with the intangible property. For example, a towel with a licensed cartoon character affixed to it sells primarily because of the cartoon character and not simply because it is a towel. Therefore, the licensee’s use of the intangible, and the assignment of the sale from that license by the licensor, should be assigned to the location where the towel with the cartoon character affixed to it is sold, i.e. the location of the retail customer. This approach is preferable to rules that assign receipts from licenses to where the product is manufactured because the location of manufacture is not the true use of the intangible that gives rise to the license fees. The location of the licensee reflects where the licensee employs labor and capital, but this does not fit with the intention of the new statutory scheme. Because the revisions to RTC section 25136 are intended to find, as best as can be determined, the market being exploited in California, the purchase of the underlying products containing the intangibles in California should be recognized in assigning the licensee fee sales. In most cases the license contract calls for a percentage of sales to be paid as the fee, so therefore it is the underlying sales of products that really reflects the market.

Subsection (d)(2)(A)1 sets forth the first rule of assignment that the contract between the taxpayer and the licensee or the taxpayer's books and records will establish the extent to which the goods are purchased by retail customers in this state and thus whether the sales will be assigned to this state. Members of the public at the interested parties meetings concur that the best evidence for determination of assignment of receipts under this regulation is the contract or the taxpayer's books and records.

Subsection (d)(2)(A)2 provides that if the information is not available to assign the sales pursuant to subsection (d)(2)(A)1, the location of the use of the intangible property (the retail customers of the licensee) is to be reasonably approximated by reference to the activities of the taxpayer's purchaser (the licensee) to the extent such information is available to the taxpayer. Reasonable approximation is a reasonable alternative for establishing the taxpayer's retail market where the contract and the taxpayer's books and records do not do so. Reasonable approximation can include a population proxy but only based on the population data where the licensee uses the intangible to market goods. Several states including Illinois use population data as a proxy for the establishment of the ultimate customer. Comments at interested parties meetings indicate that population is a reasonable proxy for establishing a taxpayer's retail market provided that the population used be in geographic areas where the taxpayer actually has sales.

Subsection (d)(2)(A)3 provides a special rule where the licensee does not sell directly at retail and therefore neither the taxpayer nor the licensee would have information on where retail sales occur. Where the sale is at the wholesale level rather than to retail customers, then the taxpayer may use the percentage of this state's population to the total population of the geographic area in which the licensee markets its goods. A limitation is provided that the population of foreign countries can only be used if the intangible is materially used in marketing goods in a foreign country. Population data is considered by the public and the staff of the Franchise Tax Board alike to be a reasonable proxy for establishing a taxpayer's market in this circumstance.

Subsection (d)(2)(B) entitled "Non-marketing and manufacturing intangibles" provides the rules for assignment of sales where a license is granted for the right to use intangible property in a manufacturing process or for another non-marketing purpose. This type of sale is assigned to the location where the intangible property is used, i.e. the manufacturing plant or other place of use, rather than the location of the ultimate consumer who purchases the manufactured product. The premise for this method of assignment is that the licensee's use for these types of intangibles is primarily in the manufacturing activity itself rather than in the marketing of the product produced. In addition, taxpayers with these types of licensing sales will likely be unable to establish the ultimate retail market because licenses of technology to manufacturers can be used in a variety of different ways for a variety of different products and in some circumstances the end-product is not even manufactured by the licensee of the technology. As a result, retail customer information is often not available to the licensee (purchaser) of the taxpayer's license. This rule parallels RTC section 25127, which provides rules for the assignment of nonbusiness income arising from patents.

Subsection (d)(2)(B)1 provides that the primary rule that the contract between the taxpayer and its licensee, or the taxpayer's books and records, is presumed to indicate the extent of

the use of the intangible property is in this state. Either the taxpayer or the Franchise Tax Board may rebut this presumption by showing that the place of use is not shown by the contract or the taxpayer's books and records. Members of the public at the interested parties meetings concurred that the best evidence for determination of assignment of receipts under this regulation is the contract or the taxpayer's books and records.

Subsection (d)(2)(B)2 provides the second rule of assignment that the location of the use of the intangible property is to be reasonably approximated by reference to the activities of the licensee to the extent this information is available to the taxpayer. This second rule only applies if the first rule cannot be applied. Interested parties meetings participants felt that in the absence of best evidence, i.e. the contract or the taxpayer's books and records, a reasonable approximation of the location of the use of the intangible property would be the best alternate method of assignment of receipts under this regulation.

Subsection (d)(2)(B)3 provides a third rule of assignment which is the state of the licensee's billing address. This rule only applies if the first two rules cannot be applied. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(2)(B)1 or 2.

Subsection (d)(2)(C) entitled "Mixed Intangibles" provides the segue for the rules for assignment of those sales where a license is granted for the right to use intangible property in both a marketing and manufacturing or other non-marketing purpose.

Subsection (d)(2)(C)1 provides that where the fees for the marketing are separately stated in the licensing contract from the fees for the manufacturing or other non-marketing purpose, then the fees shall be assigned based on that separate statement. However, if the separate statement is not reasonable, then the Franchise Tax Board may use a reasonable method that accurately reflects each use of the intangible property. This language establishes that the taxpayer's contract will be taken at face value unless it is unreasonable.

Subsection (d)(2)(C)2 provides that where the fees are not separately stated, then it is presumed that the fees are paid entirely for the intangible property in connection with the marketing of goods, services or other items. Either the taxpayer or the Franchise Tax Board is allowed to establish that the fee was not paid exclusively for marketing. This provision is to encourage taxpayers to separately state in their licensing contracts their marketing fees from their non-marketing fees so that their marketing and non-marketing fees, as sales of intangible property, are accurately assigned under this regulation.

Subsection (d)(2)(D) provides examples for how to assign sales in connection with the licensing of intangible property in subsections (d)(2)(A), (B) and (C) above. Example 1 illustrates assignment pursuant to subsection (d)(2)(A)1 in connection with a marketing intangible where the licensing fees are based on a percentage of total products sold in each state. Example 2 illustrates assignment pursuant to subsection (d)(2)(A)2 in connection with a marketing intangible using a reasonable approximation method. Example 3 illustrates assignment pursuant to subsection (d)(2)(B)1 in connection with a non-marketing intangible using the taxpayer's contract and books and records. Example 4 illustrates an assignment pursuant to subsection (d)(2)(C)2 in connection with mixed intangible under an agreement which does not separately state marketing and manufacturing licensing fees. Example 5

illustrates assignment pursuant to subsection (d)(2)(C)1 in connection with a mixed intangible under an agreement that does separately state marketing and manufacturing licensing fees. These examples were based on other states' examples which states have similar statutory and/or regulatory language, including Massachusetts. Members of the public at the interested parties meetings wanted examples to show how each cascading rule works and the examples above were discussed at the interested parties meetings. Examples need to be added to show assignment pursuant to subsections (d)(2)(A)3, (d)(2)(B)2 and 3, and (d)(2)(C)1.

Subsection (e) provides that sales from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state. This rule is identical to the statutory provision, RTC section 25136, subdivision (b)(3), and requires no further elaboration.

Subsection (f) provides that sales from the rental, lease, or licensing of tangible personal property are in this state if the tangible personal property is located in this state. There is an example provided. This rule is identical to the statutory provision, RTC section 25136, subdivision (b)(4). No further elaboration is necessary.

Subsection (g) provides introductory language to the special rules for this regulation.

Subsection (g) (1) states that the Franchise Tax Board must consider the effort, expense and resources required of a taxpayer to obtain the necessary information to assign sales under RTC section 25136, subdivision (b). The Franchise Tax Board may accept a reasonable approximation where appropriate such as when a smaller business cannot develop the necessary data from its financial records kept in the regular course of its business. Comments received at the interested parties meetings indicated that taxpayers wanted a provision similar to Ohio's where taxpayers would not be required to go to considerable effort and expense to update their computer systems or other data in order to be in compliance with the new statute and this regulation. This provision is based on Ohio's similar provision. An example is provided. This example was discussed at the interested parties meetings.

Subsection (g)(2) provides that in determining customers' or licensee's use of intangible property in connection with "Marketing Intangibles" under subsection (d)(2)(A)2, factors to be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold in each state, or other data including population. This language provides guidance as to how to "reasonably approximate" marketing intangibles. It is based on a Wisconsin regulation in connection with determining the location of the use of intangible property.

Subsection (g)(3) segues for special rules in determining reasonable approximation of the location of the market for the benefit of the services or the location of the use of intangible property.

Subsection (g)(3)(A) states that once a taxpayer has used a particular reasonable approximation method under any provision of the regulation, then the taxpayer must continue to use that method in subsequent taxable years. To use a different method the

taxpayer must seek permission of the Franchise Tax Board. This provision was discussed in interested parties meetings by taxpayers who argued that as long as their method was reasonable, taxpayers ought to be able to continue that reasonable method. The Franchise Tax Board agreed that taxpayers should be consistent in their reasonable approximation method from year to year and felt that if the taxpayer chose to use a different method, then the Franchise Tax Board should be allowed to approve of the alternate method. Members of the public at the interested parties meetings did not disagree.

Subsection (g)(3)(B) states that the method of reasonable approximation must reasonably relate to the income of the taxpayer. For instance, if the taxpayer includes countries in its reasonable approximation for which no sales exist, then the taxpayer's method for reasonable approximation does not reasonably relate to its income. This provision is to ensure that reasonable approximation relates to where the taxpayer conducts its business. Members of the public at the interested parties meetings did not dispute the reasonableness of this provision.

Subsection (g)(4) incorporates, with appropriate modifications, provisions under CCR section 25137 into the regulations under RTC section 25136, subdivision (b). Subsection (g)(4)(A) provides that references in the regulations promulgated under RTC section 25137 that refer to RTC section and CCR section 25136 shall, for purposes of section 25136, subdivision (b), refer to RTC section and CCR section 25136, subdivision (b). Subsection (g)(4)(B) states that CCR section 25137(c)(1)(C) [Special Rules. Sales Factor] is not applicable. Subsection (g)(4)(C) states that the provisions in CCR section 25137-3 [Franchisors] that relate to the taxpayer not being taxable in a state are not applicable. Subsection (g)(4)(D) states that the provisions in CCR section 25137-4.2 [Banks and Financials] that relate to income-producing activity and costs of performance and throwback are not applicable. Subsection (g)(4)(E) states that the provisions in CCR section 25137-12 [Print Media] that relate to a taxpayer not being taxable in another state and the sale's inclusion in the sales factor numerator if the property had been shipped from this state is not applicable. These modifications, eliminating references to cost of performance and throwback rules, are in keeping with market-based rules of RTC section 25136, subdivision (b), which is operative for taxable years beginning on and after January 1, 2011. Members of the public and the Franchise Tax Board at the interested parties meeting agreed that these changes are appropriate under the new scheme of RTC section 25136, subdivision (b).

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting proposed Regulation section 25136(b), the Franchise Tax Board relied on its fifty (50) state analysis of other states' market-based statutory and regulatory rules and three interested parties meetings held in February, July and November of 2010. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation, or would be

less burdensome with respect to affected private persons or small businesses than the proposed regulation. The proposed regulation pertains only to corporate taxpayers and therefore does not affect private individuals. In addition, it pertains only to multistate and multinational businesses and therefore will have little or no impact on small business.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed regulation under RTC section 25136, subdivision (b), will not have a significant adverse economic impact on business beyond the impact that the statute itself imposes, if any. The proposed regulation primarily explains to multistate corporations how to assign sales of other than tangible personal property based on market rules.